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US Business Tax Reform Would Be Healthy for the World Economy

By Duanjie Chen and Jack M. Mintz

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As Americans and the rest of world begin to fret about a possible US downturn affecting world economic growth, they should include in their list of concerns a US business tax system that is overly complex, inefficient and uncompetitive. The US shares the spotlight with Argentina, Brazil, China, Germany and the Republic of Congo in having one of the highest effective tax rates on capital among 81 developed and developing countries. This tax burden is not only unhealthy for investment, but also eventually undermines US and, hence, world economic growth by slowing investment and deterring companies from adopting innovative technologies.

The effective tax rate is a broad measure of the tax burden on business that takes into account corporate income taxes, sales taxes on capital purchases and other capital-related taxes. The higher the rate is, the easier it can kill capital investments by business in new machines, structures, land or inventory. When a company is determining whether to invest its capital, especially in the case of marginally profitable projects, it must make sure that the risk-adjusted rate of return on capital is at least equal to the cost of capital. For example, if the risk-adjusted rate of return on capital is 10 per cent, a 40 percent effective tax rate on capital reduces the rate of return on capital to 6 percent. If businesses require at least a 6 percent rate of return (net of risk) to compensate investors for investing in the business, then the company will be willing to undertake a new capital project.[1]

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1 The analysis takes into account differences in definitions of the tax base (such as depreciation and asset values) as well as statutory corporate tax rates on profits that are provided in the first column of the table.

At 38 percent, the US effective tax rate on capital is above its neighbours — high-tax Canada at 36.6 percent and low-tax Mexico at 13.8 percent — and well above the GDP-weighted average of 31 percent. This reflects a high statutory corporate income tax rate (only surpassed by Chad and Japan) as well as state retail sales taxes applied to capital purchases. Since 2005, the US has been phasing in a 3.15-percentage-point reduction in its statutory profit tax rate for "domestic producers," including manufacturing and some other selected industries. After this phase-in period ends in 2009, the statutory company income tax rate for the manufacturing industry will be 31.85 percent. This change will not address US uncompetitiveness in these and other sectors, but will further complicate its cumbersome business tax structure.

The US joins a list of tax-burden bad boys headed by the Republic of Congo, which has the highest effective tax rate on capital, at about 56 percent. Congo's dubious distinction comes as a result of a special business tax that largely offsets generous deductions for investments in manufacturing. The runner-up is China, surprisingly, which has the next highest effective tax rate, at about 47 percent, largely driven by its non-refundable 17 percent VAT applied to purchases of machinery. To attract some investors, Chinese provinces sometimes offer relief by refunding the VAT on machinery, which reduces China's effective tax rate on capital to 18 percent.

The most tax-favoured jurisdictions include the usual suspects like Hong Kong SAR at 6.1 percent, Singapore at 11.5 percent and Ireland at 14 percent, reflecting their low corporate income tax rates. Belgium has the lowest effective tax rate on capital amongst all 81 countries at -4.4 percent, resulting from the introduction of a notional deduction for equity financing.[2] With both bond and equity financing deductions, unadjusted for inflation, Belgian companies are able to claim a higher tax value of deductions compared to the tax levied on income earned from investments.

The US certainly looks like a high-tax country when it comes to business taxation. A 2005 report prepared by a special commission appointed by President Bush recommended substantial tax reform that would reduce complexity and barriers to economic growth. One proposal would have eliminated the corporate tax on marginal investments by allowing companies to write off capital investments immediately, while disallowing a tax deduction for interest expenses. Although this reform in itself would be a large step forward, the commission report was spot on in making clear that the US corporate tax system is a major barrier to investment and growth, degrading other strengths of the US economy.

The US corporate tax system is also highly complex, with special deductions for preferred business activities. Instead of using the tax system to interfere with economically sound business decisions, it would be much better to have a broad-based neutral corporate income tax with low rates to create a better business environment. Simplification would make it easier for taxpayers to comply with the system and for the IRS to administer the tax system. The saving in compliance and administrative costs would be good for the US economy as well.

2 The notional deduction is equal to a risk-free, long-term government bond rate applied to shareholders' equity.

Table 1: *General Corporate Income Tax Rates and Effective Tax Rates on Capital by Country, 2006 (in percentages)*

	General Corporate Income Tax Rate	Effective Tax Rates on Capital		
		Manufacturing	Services	Average
Congo*	38.0	42.6	56.7	55.7
China*	24.0	47.5	46.4	46.9
Argentina	35.0	47.0	43.6	44.3
Brazil	34.0	40.0	38.4	38.8
Germany	38.4	39.2	37.7	38.1
US	39.2	34.8	40.2	38.0
Russia	22.0	40.0	36.7	37.6
Canada	34.2	33.1	39.6	36.6
Chad*	45.0	37.0	34.2	34.8
Japan	41.9	36.2	31.2	32.2
France	35.4	33.1	31.9	32.1
Korea	27.5	32.9	31.0	31.5
Pakistan*	35.0	30.4	31.4	31.2
Spain	35.0	32.0	29.9	30.2
India*	33.0	29.2	30.4	30.2
Iran*	25.0	31.4	29.5	30.0
Costa Rica*	30.0	38.8	29.5	29.7
Indonesia*	30.0	31.2	27.2	28.7
UK	30.0	23.9	29.4	28.5
Ethiopia*	30.0	31.5	27.3	28.1
Tanzania*	30.0	27.0	26.1	26.2
Tunisia*	35.0	25.7	26.0	26.0
Iceland	18.0	27.4	25.4	25.7
Botswana	25.0	14.5	26.4	25.6
New Zealand	33.0	31.2	24.1	25.4
Kenya	30.0	33.1	23.9	25.3
Sierra Leone	35.0	14.0	27.2	25.3
Lesotho	25.0	11.3	28.0	24.3
Uzbekistan	21.8	27.2	22.5	23.7
Australia	30.0	28.3	22.9	23.6
Italy	37.3	22.0	23.5	23.2
Finland	26.0	22.7	23.1	23.0
Kazakhstan*	30.0	24.5	22.0	22.5
Norway	28.0	25.1	21.8	22.3
Bolivia	25.0	26.0	21.0	22.2
Netherlands	31.5	23.9	20.0	20.6
Luxembourg	30.4	24.3	20.2	20.5
Trinidad and Tobago*	30.0	5.8	26.2	20.4
Malaysia*	28.0	21.4	19.6	20.3
Greece	32.0	25.4	19.3	20.1
Peru*	30.0	23.4	18.9	19.8
Fiji	31.0	21.5	18.9	19.4
Bangladesh*	30.0	12.5	21.1	19.4
Austria	25.0	21.6	18.5	19.2
Thailand*	30.0	20.7	18.0	19.1

There is clearly more to economic growth than tax rates on capital investment. Some countries that rank poorly on tax rates are attractive to investment; others that rank well are not. When other factors are deteriorating, however, as is the case with large current account deficits and a slowing economy, uncompetitive tax rates threaten growth in the world's most dynamic economy.

Economic studies have shown that reductions in effective tax rates on capital could significantly improve capital formation (see Mintz 1995). One recent study by two Dutch economists has shown that a 1 percent reduction in the effective tax rate increases foreign direct investment by about 3.3 percent (de Mooij and Enderveen 2003).

The US is not the only large country that would benefit from tax reform. Clearly, Brazil, China, Russia and most of the G-7 countries should look at reducing tax rates and broadening tax bases to improve their tax systems. For the good of the world, the US and other large countries could help lead the way to greater global economic growth, which could well be a significant issue for 2007 as economies slow down.

References

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Table 1: *General Corporate Income Tax Rates and Effective Tax Rates on Capital by Country, 2006 (in percentages) cont'd.*

	General Corporate Income Tax Rate	Effective Tax Rates on Capital		
		Manufacturing	Services	Average
Vietnam*	28.0	24.4	17.0	19.0
Uganda	30.0	9.9	20.1	18.6
Georgia	20.0	20.4	17.7	18.2
Sweden	28.0	19.3	17.5	17.8
Jamaica	33.3	12.3	18.6	17.7
Jordan*	25.0	11.4	19.4	17.4
Madagascar*	30.0	23.4	15.2	17.0
Hungary	16.0	19.6	15.6	16.5
Switzerland	16.7	16.4	16.5	16.5
Poland	19.0	15.9	16.4	16.3
South Africa	29.0	17.7	15.3	15.8
Rwanda*	30.0	21.4	14.5	15.5
Denmark	30.0	18.9	14.8	15.4
Mauritius*	25.0	8.7	15.8	14.3
Ireland	12.5	12.6	14.6	14.0
Mexico	30.0	18.0	12.8	13.8
Portugal	27.5	15.7	13.4	13.8
Morocco*	35.0	12.3	13.9	13.6
Slovak Republic	19.0	14.0	12.2	12.6
Chile	17.0	13.0	12.0	12.3
Egypt	20.0	10.8	12.2	11.9
Singapore*	20.0	7.3	13.1	11.5
Czech Rep	26.0	13.3	10.5	11.2
Ghana*	25.0	11.1	9.6	9.9
Romania*	16.0	10.5	8.8	9.3
Croatia*	20.3	10.9	8.5	9.3
Ecuador	25.0	10.0	7.6	8.2
Bulgaria*	15.0	7.9	7.8	7.8
Serbia*	10.6	4.6	9.1	7.8
Ukraine	25.0	14.2	5.5	7.7
Hong Kong SAR	17.5	3.6	6.2	6.1
Latvia*	15.0	6.6	5.5	5.7
Zambia	35.0	16.8	-1.3	1.4
Nigeria*	32.0	5.4	-0.4	0.4
Turkey	30.0	6.9	-2.5	-0.2
Belgium	34.0	-5.9	-4.0	-4.4

Notes: Effective tax rates on capital investments incorporate corporate income taxes, sales taxes on capital purchases and other capital-related taxes including asset and net worth taxes, stamp duties on securities, taxes on contributions to equity. Property taxes are not included due to lack of data.

* Conditional tax holiday regimes operating in some countries (marked with an asterisk) are not included in the analysis.

Source: International Tax Program, Institute of International Business, University of Toronto.